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# Reform of China's Rural Industry: The Disadvantages of Rapid Growth

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An Intelligence Assessment

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EA 86-10008  
March 1986

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# **Reform of China's Rural Industry: The Disadvantages of Rapid Growth**

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**An Intelligence Assessment**

This paper was prepared by [ ] Office of  
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welcome and may be directed to the Chief, China  
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*EA 86-10008  
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## Reform of China's Rural Industry: The Disadvantages of Rapid Growth

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### Summary

*Information available as of 15 February 1986 was used in this report.*

The development of rural industry—a key element in China's economic reform program—is proceeding much too rapidly for Beijing to control or sustain, and is causing serious economic and political problems for the regime. Spurred by government incentives, eased credit restrictions, and enhanced business opportunities, rural enterprises—ranging from shoe repair stalls to small coal mines and factories—grew nearly 45 percent in 1984, and about the same rate in 1985. At the beginning of last year, the sector was already producing more than one-fourth of the nation's coal, 40 percent of its garments, and three-fourths of the output of building materials. This hyperactivity, however, has drawn resources away from grain production, contributed to inflation, weakened Beijing's efforts to control the economy, and facilitated corruption among rural officials.

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China's reformers have long viewed rural industrial development as crucial to China's modernization. In general, it is intended economically to link agriculture to industry, and specifically to benefit China's food-processing industry, the state's transportation network, the much-needed services sector, and long-neglected rural consumers.

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Politically, the program is part of an effort to transfer successful reform experiences from the countryside to the cities. Some reformers appear to believe that it will also prove the practicability of loosened central controls and greater market influence over economic activity. Rural industry does indeed appear to be the sector most responsive to free market reforms. Free of excessive bureaucratic controls, rural industrial entrepreneurs have been aggressive in establishing new products and services, marketing their output, and responding to nascent market signals.

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Most important, however, Beijing's rural industrialization policies reflect demographic necessities. The success of agricultural reforms since 1979 has given China excess farm labor. Over 160 million peasants have left farming to work for other enterprises on at least a part-time basis, and Chinese officials expect that over 200 million more will do so before the end of the century. Beijing intends to prevent this potentially migratory labor force from moving to China's already overcrowded cities, and instead to channel it to small satellite cities, where former peasants will engage in small-scale rural industries.

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In our view, runaway growth began in the rural industrial sector during 1984-85 as a result of unchecked peasant enthusiasm for establishing small-scale businesses, driven in part by the government's claim that rural industry was a way to "get rich through labor." Poorly developed credit policies and insufficient understanding of government goals by local officials were also major factors in the problems that developed. Beijing has responded belatedly with measures to limit rural credit and punish corruption, but the continued high growth rate for rural industry indicates that the problem is not under control. We believe that new problems will be exposed as inefficient and poorly managed rural enterprises begin to go bankrupt.

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But, at the same time, the expansion of the rural industrial sector has raised the quality of life for many of the 800 million inhabitants of rural areas. The income of families engaged in rural enterprises averages 24 percent higher than those specializing in agricultural production, and rural industry throughout the country is beginning to provide peasants with a greater variety of consumer goods and services. In addition, rural enterprises have helped ease critical economic bottlenecks, particularly in energy and transportation.

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Conservative critics of the rapid pace of economic reform, led by Politburo Standing Committee member Chen Yun, have seized upon problems related to rural industry—including the credit binge, corruption, and a drop in grain production—to step up their attacks on the reformist leadership. Implications that the reformers have mishandled rural economic policy—the very area where they have achieved their most impressive success in the past—have been more damaging than charges that the reforms are ideologically suspect. Although the reformers are on the defensive, they have been able to hold their ground and are insisting that the programs will be continued.

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We believe rural industrial policies are so important to China's reformers—who have invested so much political capital in the program—that they have little choice but to continue. Rural industrial growth, therefore, is likely to continue to lead other sectors of the economy, at least for the short term. Rather than stimulate the sector any more, however, we believe Beijing will stress controlling the growth through financial institutions, reducing the waste and corruption through disciplining local officials, and guiding the output of rural industries through regulatory means.

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In our view, Beijing will find it difficult to control rural enterprise growth through its normal administrative policies without resorting to heavyhanded methods that would dampen economic activity excessively. Although a "socialist commodity economy" under free market controls may be ideologically unpalatable to some conservatives, that is the direction in which China's rural economy is moving, and we believe it is too late to turn back without serious social, political, and economic consequences. We believe that the reformers are preparing for a "shakeout" period of market discipline, during which some of the rural industries will be allowed to fail. This is likely to be a politically difficult period, as the government attempts to insulate the rest of the economy and society from the effects of large numbers of bankruptcies.

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In the longer run, however, we believe rural industrial policies will accomplish most of the goals reformers have set for them: creating a more diversified, efficient, and active economy. China hopes that an increasing share of its light industrial products and foodstuffs will be exported. The United States undoubtedly is viewed as a major potential market for these goods, and Beijing's efforts to develop trade links and join international organizations, such as the GATT, may be partially motivated by its future plans for the export of light industrial goods. In general, however, small-scale industries will have less of an impact on trade than on the development of the domestic economy.

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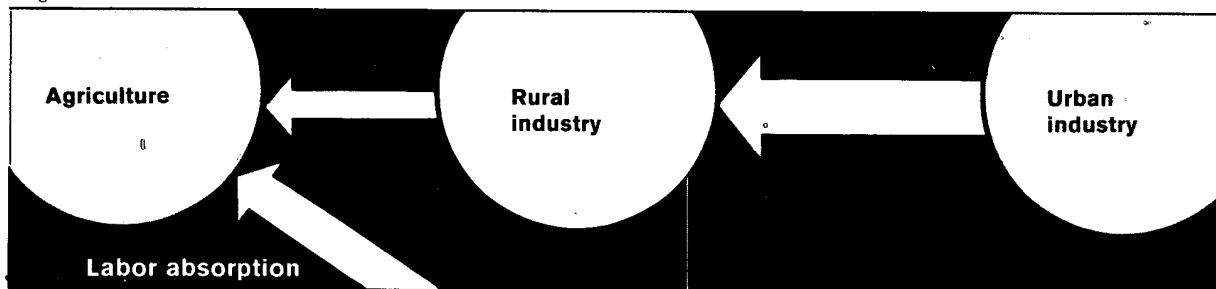
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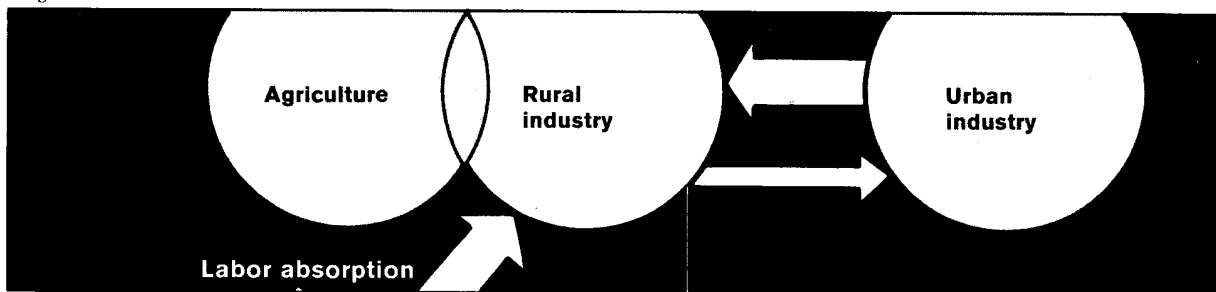
**Figure 1**  
**Beijing's View of the Development Stages**  
**of Rural Industrial Integration**

□ Technology flow

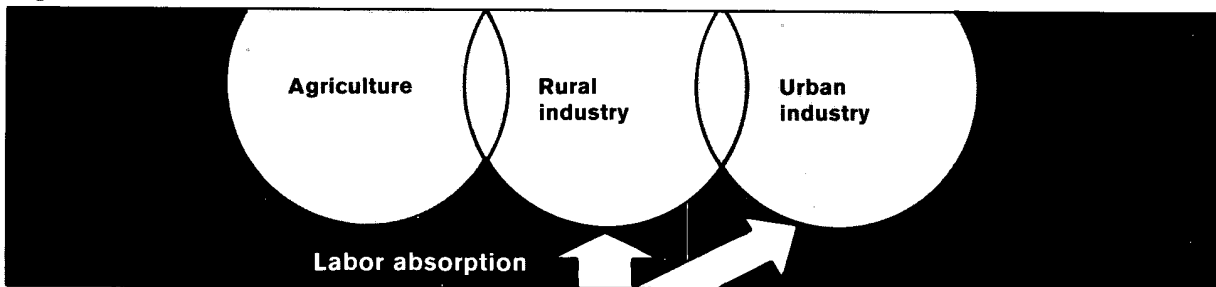
Stage One



Stage Two



Stage Three



Under Mao Zedong's leadership, collectives were allowed to develop only a very small rural industrial sector for processing agricultural produce for urban consumers and repairing and maintaining agricultural machinery. China is currently entering stage two of its plan, as rural industry begins to show a degree of sophistication and differentiation, and to supply components and products to the urban industrial sector. Agriculture is also becoming more closely integrated with rural industry as, for example, peasants process and market more of their crops and begin holdings more than one job.

We believe that China's final goal is for the difference in products and quality between the two industrial sectors to largely disappear. The development and integration of rural industry will theoretically increase the incomes of the agricultural sector, simultaneously providing a market for the further expansion of the industrial sectors.

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## Reform of China's Rural Industry: The Disadvantages of Rapid Growth

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### Rural Industry: Spurring Modernization and Absorbing Labor

China's economy for the past two years has generally been hampered by a problem of unbalanced growth and overheating. Although the urban industrial sector has been the focus of most Chinese as well as Western attention (with an overall growth rate in 1985 of about 18 percent), rural industry has been leading the economy with 45-percent growth in 1984 and an estimated similar rate for 1985. This frenetic growth has contributed to several of China's more serious economic problems, including inflation, shortages of capital and construction materials, and lowered grain production. Because the hyperactivity in the rural industrial sector is a direct result of deliberate government stimulation, the burgeoning problems have generated political controversy as well.

In our judgment, Beijing had a variety of motives when it introduced new policies in 1984 to promote rural industrialization. In practical economic terms, the policies were designed to develop the much-needed service sector, improve the food-processing industry, make more consumer goods available to rural inhabitants, and ease the burden on the state's distribution and transportation networks. In a larger, more ideological framework, many Chinese leaders see rural industry as the key to a socialist integration of the country, linking agriculture to industry and cities to the countryside (see figure 1). Some reformist leaders appear to view the rural industrial sector as a proving ground for the development of a "socialist commodity economy," with heavy elements of free market exchange.

Principally, however, the rural industrial development program has been driven by demographic necessity. Agricultural reform policies introduced since late 1978 have been highly successful, more than doubling

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### Definition of Rural Enterprises

Beijing defines rural enterprises as businesses owned or operated by any of the following: townships, villages, production teams, combinations of several families, and individual households. The present-day township is equal in size to what was called the commune before its economic and political functions began to be separated in 1982. Communes were made up of brigades, which are now called villages or towns. Production teams, the third tier of the former collective accounting structure, have retained their name and usually consist of roughly 20 to 30 families.

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The term rural is somewhat misleading, because many of the enterprises are in towns and may employ as many as several hundred workers. Rural enterprise statistics are also an odd blend of agricultural and industrial figures. For accounting purposes, China in the past considered rural industrial production below the commune level as agricultural output, while commune level and above was considered as industrial output. Starting in statistical reports for 1985, however, output value from the former brigade- and team-run industries is included in industrial output.

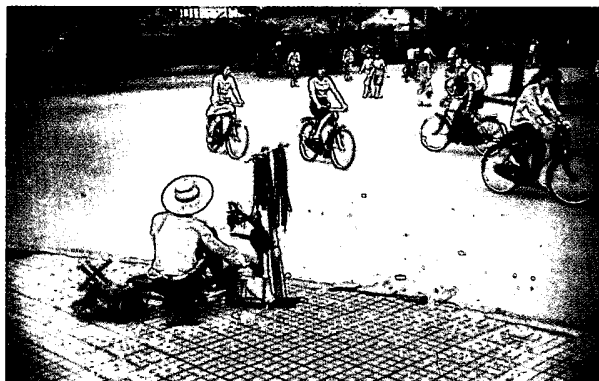
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Rural enterprises were traditionally engaged primarily in food-processing and agricultural machinery industries, linking the rural areas to the cities. But rural enterprises have expanded rapidly and now include a myriad of light and heavy industrial, transportation, and service enterprises.

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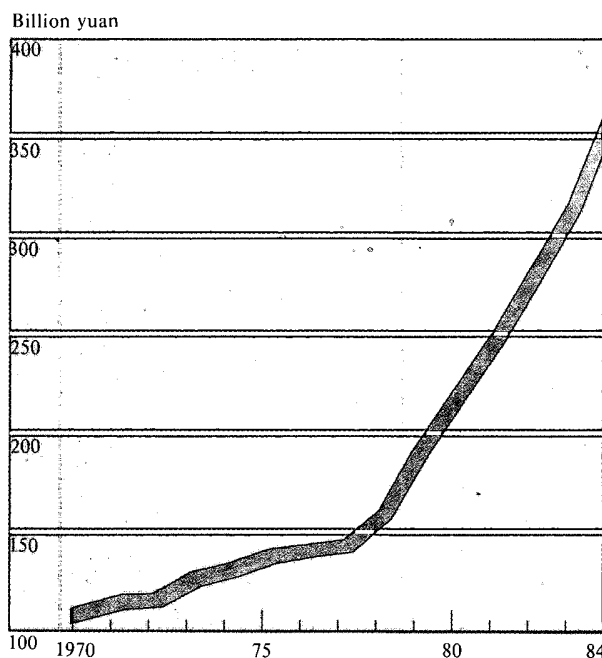
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Peasant in Zhejiang Province who has given up farming to open a street-side leather repair business.

the value of farm production (see figure 2).<sup>1</sup> The increased productivity and specialization of agriculture have led to an excess of rural labor. Already some 60 million peasants have left agriculture, and Beijing estimates that an additional 100 million peasants are working in agriculture only part of the year. Xinhua, the official Chinese press, recently reported that over the next five years 30 million young people will enter the labor force, 10 million more will be rendered redundant as the result of reconsolidation of collective enterprises, and 100 million peasants will leave the land to enter rural industrial and service enterprises. In effect, it has taken only two years to change the traditional role of Chinese agriculture from being the employer of last resort for the urban unemployed to becoming the source of labor to develop industry. The Rural Policy Research Center in Beijing estimates that by the end of the century 40 percent of the rural labor force will be involved in

<sup>1</sup> The new policies, usually referred to as the production responsibility system, raised agricultural prices and broke up the traditional collective accounting structure. Contracts replaced strict production and acreage quotas, communal land was divided among individual families, and farmers were permitted to make their own production decisions. Diversification of production away from grain has also been encouraged, with families and collectives to specialize in the product in which they have the greatest comparative advantage. Families wishing to engage in rural enterprises are allowed to sublease their fields to other families specializing in crop production.

**Figure 2**  
**China: Gross Value of**  
**Agricultural Output**



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rural enterprises. This implies that in the next 15 years the number of peasants leaving agricultural production will be roughly equal to the current population of the United States.

#### Market Towns Become Key Link

Beijing has taken several steps to keep the peasants leaving the farm from migrating to urban areas. Cities can grant urban residency status to very few peasants, and strict short-term residency standards have been drawn up for peasants working in cities for short periods. In our view, a system being adopted that will require all citizens to carry a personal identification card is partially motivated by the desire to monitor and control the rural-urban population flow.

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Beijing hopes instead to move peasants into smaller "market towns"<sup>2</sup> whose development is to be directed by local and regional officials. In effect, the policy encourages the creation of a giant network of suburbs, or satellite towns. Guidance on construction of the towns has come from both national and provincial levels, telling local officials to select and develop the towns carefully in light of their resources and potential. [ ]

Despite problems—the press indicates that, in the haste of construction, most market towns are growing haphazardly without any master plans—market towns are important to Beijing's ideologues as well as its economic planners. They represent the bridge to integrate industry with agriculture, as well as cities with rural areas. To develop successfully, rural industry requires both labor, raw materials, and capital from the agricultural sector and the technology and markets provided by urban industry. [ ]

#### Reasons for Rapid Growth

Although the Chinese Government has always encouraged the development of small-scale industries by rural production units, the rapid growth of the last two years is, in our view, a direct result of new state incentives and the ready availability of investment funds. Equally important, however, was the political support given to rural industrialization by high-level party leaders, especially General Secretary Hu Yaobang. Party propagandists laid heavy stress on the idea that peasants could "get rich through labor" by engaging in rural enterprise development, and publicized numerous examples of peasant families who became "10,000-yuan households" through such endeavors. [ ]

<sup>2</sup> There appear to be varying definitions of what actually constitutes a rural market town—announcements of the current number of such towns range between 20,000 and 60,000. In general, the cities are government seats that are being developed into industrial, social, political, and commercial centers. The cities are to be of small and medium size but linked to large cities and other market towns to facilitate trade and communications. The US Embassy in Beijing reports that current plans are for 2,400 new market towns, and for the rest of the peasants to be absorbed by raising the population of existing small towns to 40,000, from an average of about 23,000 at present. [ ]

**Government Incentives.** Government directives since early 1984 have centered on encouraging the development of rural enterprises and freeing marketing channels to allow them to operate freely and efficiently. Some of the regulations since that time have allowed:

- The establishment of service and commercial operations in small towns.
- Liberalized loans for rural enterprises.
- Linking of managers' salaries to profits.
- Greater control of hiring, firing, and wages by local managers.
- Increased access to relevant production technology and management techniques. [ ]

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The most dramatic example of Beijing's new attitude toward small business has been its massive program of divestiture. According to a Ministry of Commerce announcement in August, the national government has turned over the management of 55,000 businesses—nearly 70 percent of its small, state-owned businesses—to collectives, groups, or individuals. The entire ownership of 5,000 of these businesses has been turned over to collectives, some of which are issuing shares to their members, creating the equivalent of employee-owned corporations. According to the Ministry of Commerce, these enterprises usually have annual profits of less than 200,000 yuan (US \$67,000) and include enterprises such as general stores, snack-bars, tailors, barbershops, hotels, and grain shops. [ ]

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**Available Financing.** Chinese officials are pleased to point out that rural industrial production has been financed largely by local collective and individual investments rather than central funds. A recent article in the *Peoples' Daily* reported that the \$2 billion of state financial aid to town and township industries from 1979 to 1984 was only one-fourth of the gross taxes delivered by those industries to the state during the same period. [ ]

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**Developing Rural Enterprises: Small Coal Mines**

*The development of China's small mines illustrates many of the successes, problems, and trade-offs being made in the development of rural enterprises.*

*Small mines produce a wide variety of minerals in China, but by far the largest product is coal. In the Chinese press, small-scale mining refers to operations by townships, cooperatives, and individuals. Operations by the last two levels are referred to as rural mines, and it is in this sector that the most dramatic growth has occurred, both in terms of the number of mines and in production.*

*The growth started in 1981, when small mines were given subsidies, grants, and tax breaks. But, because central government funding mainly benefited the larger state-owned mines, small mines were developed mainly with funds from local governments and bank loans. As other rural industries developed and the price of free market coal was allowed to rise, incentives for mining increased. The US Embassy reports that the number of small mines grew 66 percent in 1983 and another 22 percent to a total of 61,000 mines in 1984. Total small mine output in 1984 was 216 million tons (actual weight), up 27 percent, and accounted for 28 percent of China's total coal production.*

*The dramatic growth has already accomplished most of the goals for which small mines were established, including:*

- *To increase energy supplies with a minimum of state investment.*
- *To provide energy to rural areas and industries where the state cannot or will not supply coal.*
- *To reduce the strain on the state's coal allocation and distribution systems.*
- *To work small deposits not economically feasible for large state operations.*
- *To increase the recovery rate for deposits already partially worked out, which larger operations prefer to ignore.*

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*However, these accomplishments have not come without some substantial, and probably largely unanticipated, costs. Small coal mines are increasingly coming under fire in the Chinese press for uncontrolled growth. Problems with the small mines include:*

- *Interference with state mining operations, including encroaching on state property and ruining state sites and equipment.*
- *Poor safety records, both for the inexperienced peasant miners and for state miners operating near them.*
- *Low quality of mined coal, which is usually unsuitable for industrial use and inequitably priced.*
- *Low efficiency, averaging only 20-percent recovery rates for small mines as opposed to an average of 50 percent for state mines.*
- *Damage to the environment from indiscriminate mining.*

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While direct state expenditures have been relatively small for the development of rural industries, the role of *state financing through bank loans* has been critical. Since 1983, Beijing has made several adjustments to the rural banking system to enable it to support specialized agricultural production and rural industry. Most of the changes involved giving the local banks more autonomy to make loans and set interest rates on loans and deposits. [ ]

Beijing has also begun turning the nation's *rural credit cooperatives* <sup>4</sup> into locally managed, dividend-paying, and profitmaking organizations. The decentralization has proved to be a major boost for rural enterprises. Loans to peasants skyrocketed, with one Chinese press report indicating that outstanding loans to rural enterprises increased 212 percent in 1984 to 15.2 billion yuan. The article stated that, for the first four months of 1985, they had increased 485 percent over the same period in 1984.<sup>5</sup> [ ]

Another major source of investment funds in the past two years has been the reemergence of the so-called *popular forms of credit*—peasant and collective funds pooled into mutual funds and stock or bond issues. According to a *China Finance* article, 30 to 40 percent of all locally raised funds for rural development came from these forms in 1984. Peasants often find these forms of credit more attractive than those of the standard financial institutions because they offer higher interest rates on deposits and are more accommodating and less bureaucratic in their loan procedures. In some cases, the interest rates charged by the popular credit organizations are several times higher than prevailing bank rates. But peasants are still willing to sign the loans because of the high returns from rural industrial enterprises. [ ]

<sup>4</sup> Rural credit co-ops were organized in the 1950s as mutual aid organizations with a high degree of local autonomy. But in the past two decades the Agriculture Bank has undercut the independence of the co-ops, increasing their bureaucracy and turning them into virtual subsidiaries of provincial agricultural banks. [ ]

<sup>5</sup> These figures may represent upward revisions of loan estimates or a mistake in the presentation of the data. Earlier Chinese announcements were approximately 100 percent lower; that is, they stated that the loans had increased to (rather than by) approximately 212 and 485 percent of the previous year's amount. In either case, it is clear that central authorities were not expecting such a large increase. [ ]

The large pool of *peasant savings* provided the remaining 60 to 70 percent of locally raised investment funds last year. Because of the increase in procurement prices and agricultural output—as well as the lack of consumer goods and agricultural inputs available for purchase—peasant savings deposits have increased between 35 and 50 percent annually from 1980 through 1984. In addition to the 200 billion yuan of peasant deposits in cooperatives in 1984, Chinese press articles estimated that peasants hold three-fourths of the currency in circulation, including 50 billion yuan stashed away in homes. [ ]

#### Were the Policies Too Successful?

The response to these policies has quickly made rural industry a major sector of China's economy. In 1984, rural industry accounted for 13 percent of the gross value of social output <sup>6</sup> and two-fifths of the gross output of the rural economy. Total profits reached almost 18 billion yuan, and taxes from the sector grew to 9.1 billion, or over 60 percent of taxes collected from rural areas. [ ]

The number of rural enterprises also increased sharply in 1984, rising from 1.4 million to 6.1 million by yearend. At that time, Beijing announced that rural enterprises employed 52 million people, or roughly 16 percent of the total rural labor force. Xinhua reports that by mid-1985 the number had risen to 60 million. [ ]

Information for the first half of 1985 indicates that the output of rural industries continued to grow at a rate more than one-and-a-half times the growth in the same period of 1984. At the beginning of 1985, the sector was producing more than one-fourth of the nation's coal, two-fifths of its garments, and three-fourths of the output of building materials. Although rural enterprises were originally envisioned as developing the nation's food-processing industry, higher profits in other operations have led to the production of a wider variety of goods. [ ]

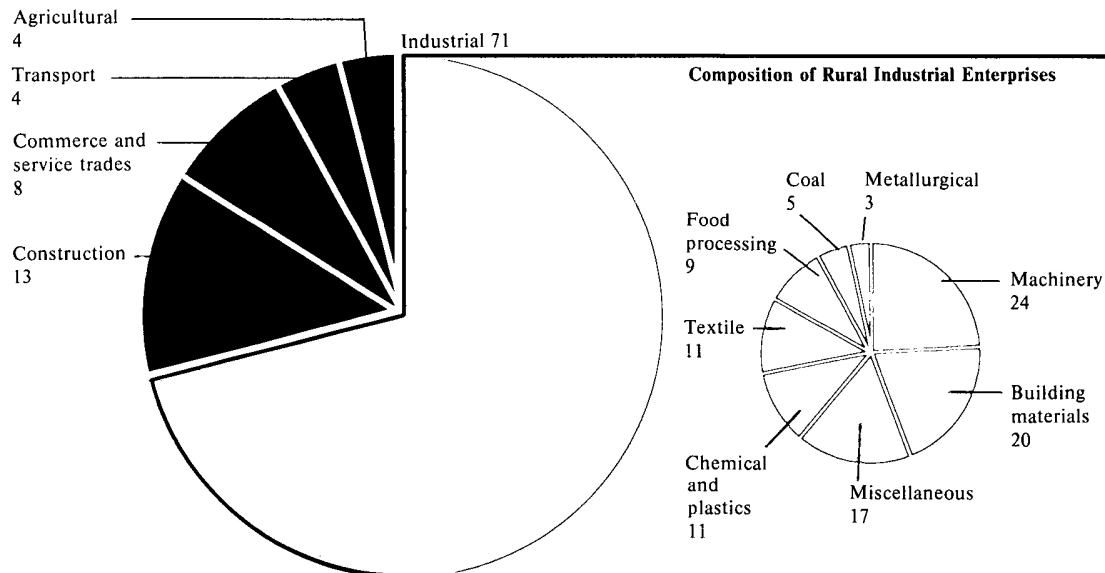
<sup>6</sup> Gross value of social output is the measure of growth for China's economy as a whole, including industry, agriculture, capital construction, transportation, business, and commerce. [ ]

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**Figure 3**  
**China: Composition of Rural Enterprise**  
**Output, 1984**

Percent



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Much of the recent growth has occurred in private business enterprises owned and run by one or more peasant families. At the end of June 1985, Chinese press reports indicate that 10.6 million private businesses (both rural and urban) with over 15 million employees had registered with the state. This represents a 14.5-percent increase since 1984 and nearly 15 times the number of private businesses in 1980. These figures probably understate the real growth because of those engaging in business without a license.

Registered private businesses include:

- 5.8 million commercial establishments.
- 1 million food stalls and restaurants.
- 800,000 transport firms.
- 750,000 repair shops.
- 650,000 service shops and stalls.
- 40,000 house-repair businesses.

#### The Positive Results

The expanding rural industrial sector has raised the quality of life for many of the 800 million inhabitants of rural areas. One 1984 Chinese survey showed that income of families engaged in rural enterprises averaged 24 percent higher than those specializing in agricultural production. Chinese press reports state that the peasant saying "no economic stability without agricultural development" has been replaced by "no prosperity without engaging in industry." And, perhaps just as important, rural industry is beginning to provide a greater variety of consumer goods and services for peasants to dispose of their rising incomes.

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***The Accuracy of Chinese Rural Statistics***

*We believe that the statistics announced by the Chinese Government are usually the best it has, and their accuracy is improving as China develops its statistical skills.* [ ]

*It is unlikely, however, that Beijing has current and reliable statistics on the vast number of changes occurring in the countryside. Indeed, the US Embassy reports that both State Statistical Bureau officials and State Council economic advisers have commented unofficially that information on the rural economy is especially poor. State Statistical Bureau officials cautioned that rural enterprise statistics are unreliable, overstated, and in current prices, while statistics on state-run enterprises are relatively reliable and in constant prices.* [ ]

*It is also apparent that definitions of new organizations and accounting methods are not uniform throughout the country. At the local level, cadre reporting is probably being influenced by ideology as well as the lack of statistical skills. For example, cadre eager to follow the new central directives on rural industry may overestimate growth and success under their administration. Likewise, Chinese press reports indicate that cadre in some areas are opposed to implementing the new reforms, which could lead them to distort their reports on rural industrial activity.* [ ]

*The Chinese-source statistics cited in this report were taken from the most authoritative sources and the most recent publication dates available. In some cases, conflicting data are given when a clear choice as to accuracy could not be made. In a few cases, our comments on the accuracy of the data are also given.* [ ]

*Following the pattern of reporting occurring in 1979-81 when the peasant responsibility system was rapidly being implemented, it is likely that the quality of Chinese statistics on rural industry will improve as uniform definitions and statistical collection mechanisms are established.* [ ]

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Rural industries have also helped draw enterprises into the sectors that have been bottlenecks for the economy, particularly energy and transportation. Over the first half of 1985, the number of people engaged in private transport businesses grew by over 40 percent, and these businesses now account for more than 40 percent of the total goods transported in China on a ton/kilometer basis. This phenomenal growth has occurred despite China's poor transport infrastructure and persistent press reports that some state transportation officials hinder private operators. The vast majority of private transport enterprises engage primarily in local hauling, and benefited from the state's decision earlier this year to increase short-haul rail freight rates. [ ]

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China has reported that energy produced by rural industries in 1984 was equivalent to 164 million tons of standard coal or 20 percent of the nation's total energy output. During the same period, those industries reportedly consumed less than the equivalent of 100 million tons of standard coal. [ ]

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Finally, a Chinese survey revealed that changes in the management of the firms had resulted in better service, higher profits, and greater satisfaction among both employees and customers. In addition to unleashing initiative by linking personal income to production, rural enterprises have other advantages over state enterprises in their ample supply of cheap labor, flexibility, and full decisionmaking power. One township enterprise official described his attitude toward competition with other businesses:

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*We have what others have not; what we have is better than others; others may have good quality but ours is cheaper; and when theirs becomes cheaper, we will shift to some new products.* [ ]

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**Trying To Control Growth**

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We believe, however, that the decentralization of authority over the rural financial system set the stage for dangerously high levels of investment in rural industry. Because of the high profits available in the

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enterprises, peasants flocked to banks and cooperatives to sign loans for investment funds. In 1984, for example, the Agricultural Bank increased rural enterprise loans by 120 percent to 48 billion yuan (\$16 billion), when its goal was for only a 20-percent increase, and loans to rural enterprises during the first quarter of 1985 rose 420 percent over the same period of 1984. Chinese officials recently told visiting US officials that the level of investment and industrial growth had taken them completely by surprise.

Moreover, the resurgence of popular credit forms, outlawed since 1949, has not come without some ideological opposition. The state is losing its monopoly over rural credit, and interest rates have also climbed dramatically as mutual fund and bond issues bid for money. Several Chinese press articles have attacked the credit forms for returning usury to the countryside.

**Beijing Clamps Down.** Alarmed at the expansion, by April of last year Beijing began announcing economic and administrative controls to slow growth and cool down the economy. The State Council transmitted orders to all banks to limit loans and the issuance of currency by:

- Limiting the credit quotas and balances of all specialized banks (such as the Agricultural Bank).
- Having the specialized banks set credit balance limits for all provinces and instruct the provincial banks on handling their loans and deposits.
- Setting guidelines on making loans only to profitable, efficient businesses producing desired goods.
- Subjecting the specialized banks to Peoples Bank regulations on deposits, credits, and interest rates.
- Requiring rural cooperatives to place at least 30 percent of their deposits in the Agricultural Bank, thus decreasing their funds available for loans.
- Requiring agricultural procurement funds to be treated as a special item and not to be lent.

The impact of the regulations was dramatic in Sichuan, according to the Chinese publication *Economic Information*. Officials there suddenly found themselves without any funds in the midst of an



Peasants digging up a field to expand a small foundry near Beijing.

unprecedented economic expansion. The revised target for Sichuan's bank loans to rural industries was dropped to 95 million yuan, down from 1.4 billion for all of 1984. But, during the first quarter of 1985, Sichuan's banks had already lent 160 million yuan to rural enterprises. All new loans were frozen, bank officials ordered rural enterprises to return 70 million yuan, and banks began to obtain working capital by making withdrawals from the accounts of some enterprises that had already invested their loans.

**Growth Continues.** By the end of August, Beijing announced that the growth in state loans had been slowed, but loans were still 20 billion yuan more than during the same period of 1984. Banks apparently had difficulty recalling loans and controlling credit, as evidenced by the inability of some banks to pay peasants for the procurement of their crops at mid-year. Some banks were criticized for not aggressively calling in their loans because bank personnel, or their friends and relatives, had interests in the enterprises. Peasants were also reluctant to repay the loans, and one county in Guangxi even increased its loans by having the local party officials threaten the bankers with the loss of their party membership if they insisted on recall.

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Moreover, even after state credit tightened in most areas, rural enterprises were continuing their expansion by using popular credit, over which the state had no direct control. Boosted by rural enterprises, nationwide expenditures on capital construction through July were up by 43 percent and industrial production had increased by 23 percent, and this trend continued to place severe constraints on prices and supplies of many goods. During that time, investment in rural enterprises had risen 87 percent nationwide, and had more than doubled in eight provinces. Bank officials were encouraged to withdraw funds from the current operations accounts of rural enterprises. No loans for new construction projects were to be made, and local banks lost the authority to make such loans. [ ]

**Turning to Administrative Controls.** Beijing evidently was not confident that simply limiting state funds was adequate, and so it turned to administrative controls. In October, the State Council ordered local governments to run a credit check on popular credit institutions and to temporarily suspend their activities. Tianjin subsequently announced the closure of a county trust and investment company, with its capital to be turned over to the state banking system immediately. The new controls and the closing of an apparently healthy investment company are probably only the first steps to control "unofficial" rural financial activity. [ ]

Although data for the second half of 1985 have not been announced, Zhang Yi, head of the Agriculture Ministry's Rural Enterprises Bureau, estimated in November that the rate of growth in rural enterprise output would decline. Zhang conceded, however, that the growth rate for 1985 will still exceed the record growth in 1984 output. He projected that 1986 would bring slower growth rates in both the sector's output and its borrowing. [ ]

#### **Problems in Production and Consumption**

This loss of control has affected other sectors of the economy as well. In agriculture, for example, the higher profits available in rural industry and industrial crop production led to a decline in the funds, acreage, and labor expended on the 1985 grain crops. *China Daily* reported in August that 1.3 million tractors, or more than one-fourth of the nation's total,

had been diverted to transport goods full time. Grain stored from previous bumper harvests has thus far kept the problem from affecting food supplies, but Beijing is clearly worried. Some areas are reinstating grain output and acreage quotas, and Jiangsu has even required rural factories to invest in farmland improvement and to give other forms of aid to grain producers. [ ]

Rural industries, particularly energy inefficient because of their small scale and obsolete equipment, are also draining China's limited energy resources. Much of their equipment was transferred to them, or even previously scrapped, because of its energy inefficiency. Although rural enterprises mined more coal in 1984 than the equivalent energy they consumed, the coal was of poor quality and not distributed nationwide, leaving areas away from coal deposits even more strapped for energy. The planned expansion of blast furnaces in one province, moreover, has led to conflicts with larger state-owned plants for raw materials, as well as cutthroat competition with other small plants. [ ]

#### **Worsening Income Distribution**

Rural enterprises are also worsening China's income distribution, which is already causing concern among conservative senior cadre, who are afraid that the growing income gaps will lead to a new class polarization in rural areas. The issue arose during the summer of 1985, and particularly during the September Conference of Party Delegates, when Politburo Standing Committee member Chen Yun castigated the party propaganda apparatus for giving too much publicity to "10,000-yuan households." The reformers moved quickly to defend rural industrialization policies, insisting that certain peasant families were bound to get rich first, before they aided other families in doing so. [ ]

The concern of conservatives will become harder to dispel, however, as income disparities remain and in fact widen under the reform policies. Although more wealthy provinces would probably have developed faster in any case, that fact was assured when state

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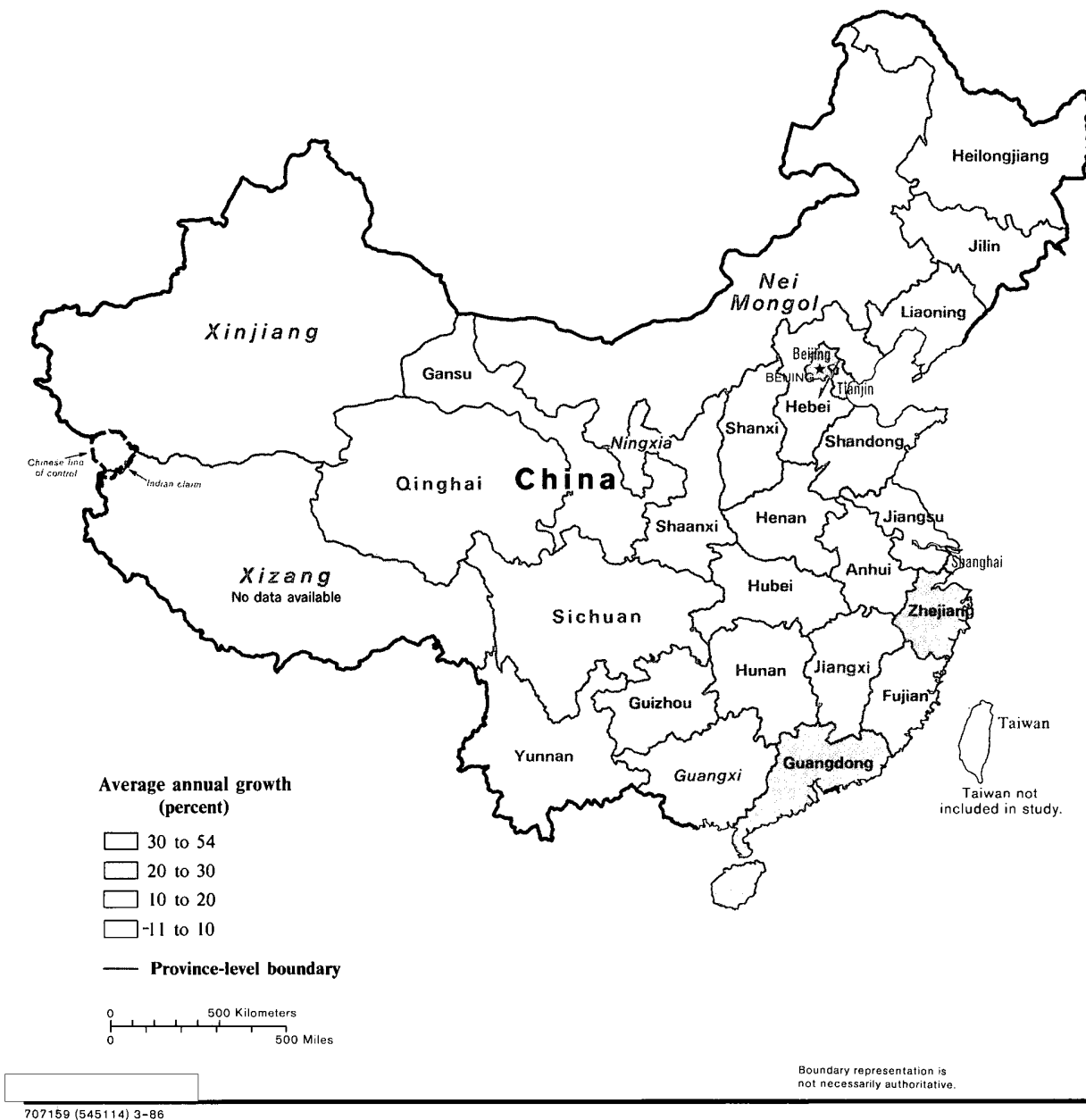
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**Figure 4**  
**Growth of Rural Industry, 1980 to 1984**



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funds were cut off in April and Beijing announced that rural enterprises were to be developed with private and collective funds. In fact, the most rapid growth has occurred in the richer, coastal provinces; poorer, inland provinces still lack the funds, technology, and market access to capitalize on enterprise development. [ ]

Beijing is undertaking several measures to improve income distribution. Supply and marketing cooperatives are being established nationwide to provide better marketing opportunities and supplies of inputs in less developed areas. The Agricultural Bank has also adopted a program to provide 300 million yuan to the poorest 200 counties in China annually through 1990, and an additional 300 million yuan was scheduled to be lent to these areas in 1985. Articles in the Chinese press have even discussed the possibility of a personal income tax, motivated, we believe, by the desire to redistribute rural income. [ ]

Several of Beijing's other long-term economic goals will be adversely affected by the development of rural enterprises. Efforts to control personal consumption expenditures may be more difficult because of the rise in disposable income and the increase in the number of consumer goods and services. In addition, rural areas probably will grow even less obedient to the state's one-child population control measures as farm labor becomes more scarce and the size of family farms increases. [ ]

#### **Parallel Concern Over Social Control**

The problems with unplanned and unbalanced economic production are perhaps symptomatic of an equally dangerous problem for Beijing—that of a growing, or at least more visible, unwillingness among peasants to subordinate personal interests. From early 1984 to mid-1985 the Ministry of Justice established more than 20,000 township law offices to handle the growing number of state and civil disputes. A steady stream of Chinese press articles is attacking economic crime, warning peasants of the punishment for criminal activity, and citing the necessity of following party discipline and state law. [ ]

This task has been more difficult because of the rapidly changing definition of economic crime. Many activities that were previously forbidden, such as nearly all rural enterprises, are encouraged. And sometimes the distinction between legal and illegal activities—allowing peasants to transport goods but not to make profits on sales at another location—remains rather nebulous. [ ]

But many rural enterprises have clearly overstepped state regulations, committing a number of crimes and producing a myriad of counterfeit goods. Provincial reports are presenting an increasingly lengthy list of fake wines, fertilizers, watches, aluminum ingots, and other goods produced by rural enterprises. The State Economic Commission has responded to the illegal activity by drafting regulations such as those for quality control of pharmaceuticals, food hygiene, the standardization of boiler pressure, and the licensing of permits for industrial production. [ ]

Another problem for local and provincial officials has been the proliferation of state loans to nonexistent companies. Such companies are referred to in the Chinese press as “briefcase” companies. The Sichuan party committee described in June how some briefcase companies had wangled loans of tens of thousands of yuan by posing as specialized households. Having secured loans from local banks, the borrowers disappeared, leaving local governments to absorb the loss. [ ]

Rural industrial development also is exacerbating already poor relations between peasants and cadre. Some officials have obstructed rural enterprises because of resentment, ideology, or simply to protect the state operations under their administration. In some cases, state-operated enterprises are unable to compete with the tax-exempt and flexible operations of rural industries and seek local government help to close them down. Policies or prices have been changed to protect state enterprises, angering peasants who believe the rules have been changed after they have

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made their investment. In other cases, enterprises have had their licenses revoked or have had lengthy interruptions of production pending state inspections. The problems of state and private competition probably will increase as private and collective enterprises expand and as officials become more responsible for the profits of the state operations under their control.

According to *Red Flag*, administrators in many areas have begun to impose charges against wealthy peasants to solve the problem of insufficient departmental funds. In one county in Guangdong, peasants wishing to own a tractor were required to pay 29 separate fees to 11 departments, including maintenance fees equal to one-third the tractor's price. Peasants in the area were evidently using the tractors mainly to engage in transport, reaping high profits in an enterprise traditionally dominated by the state.

Rural enterprises have gotten into trouble with the State Council on the question of tax payments. In a recent investigation of Hubei's 600,000 individual industrial and commercial operators who should have been paying taxes, only 370,000 had even registered to do so. Hunan estimated that 78 percent of the units and individuals in the province evaded some taxes, led by 92 percent of collective enterprises and an even higher percentage of individual traders. The Ministry of Finance began a nationwide inspection on taxation and financial affairs in August, but improvements in collections from rural enterprises probably will be difficult and slow.

#### **Reduced Political Control**

The detrimental effects of the rapid growth of rural industry have given ammunition to opponents of reform. The most visible attack was made by Chen Yun in his speech before the closing session of the National Party Conference in September. Chen emphasized grain production, implying that the successes achieved there by reform are being jeopardized by the rapid transfer of resources to rural industry. Once out of grain production, the resources, including the peasants themselves, might be difficult to put back.



*A state department store in Wuxi, Jiangsu, with brisker business occurring at a competing private stand in the alley outside.*

Chen's view is typical of that held by conservative economists in China who believe that central planning is the only way to avoid the excesses of unbalanced growth. In midsummer the conservatives launched a press attack on popular forms of credit for rural industrial development. Proponents of reform argued that all enterprises and individuals have a right to take deposits to run businesses, and that the bank's restriction on credit was blocking the free circulation of capital in the countryside. Fiscal conservatives countered with ideological opposition to unplanned growth, usury, and economic crime and warned that growth was still occurring at too rapid a pace.

The state's divestiture of its small businesses is also being criticized by conservative leaders, who see socialist enterprises being transformed into capitalist-style semiprivate operations. The new organizations have been attacked for paying out too much in profits at the expense of public welfare and for changing their operations without permission merely to obtain higher profits. The central government is therefore belatedly drawing up regulations to govern the taxing, finance, pricing, and labor management of the state/collective contracted enterprises. We believe it likely that the regulations will limit the flexibility, and therefore the success, of the contracted enterprises.

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**Confidential****Beijing's Next Moves**

Despite the problems, we believe China's reformers have little choice but to continue their program for developing rural industry because of the great investment of political capital. Rural industrial growth, therefore, is likely to continue to lead other sectors of the economy, at least through China's current five-year plan (1986-90). Rather than stimulate the sector any more, however, we believe Beijing will try to slow the growth of rural enterprises without retreating on the policies of administrative independence and price incentives. As a result, we believe that the growth rate of rural enterprises will slow in 1986 as administrative measures multiply and begin taking effect.

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Over the next few years, we also expect that rural enterprises will probably be the most fluid sector of the Chinese economy, rapidly changing its product mix and rate of growth. Of all sectors of the economy, rural enterprises have shown the greatest response to market incentives. Therefore, the sector probably will continue to be swayed as price, wage, and financial reforms are instituted for the rest of the economy. Beijing probably will feel its way along, trying to guide the sector by using a combination of financial and administrative controls. The delicate balance between the two controls will bring continuing clashes between the market-oriented reformers and the conservative proponents of a planned economy, with undecided bureaucrats and businessmen at all levels trying to circumvent the controls of both.

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Beijing hopes to export an increasing share of the output of rural enterprises to earn foreign exchange and fuel the expansion of the sector. The products will compete directly with the light industrial goods of many of China's neighbors, vying for a share of the US market. China's realization that it must increasingly engage in world markets to develop its light industry may be contributing to Beijing's efforts to join international financial and trade organizations, such as the General Agreement on Tariffs and Trade (GATT).

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## Appendix

### Continuing Economic Constraints

The past two years have shown that the reform policies will encourage growth in rural industry, but Beijing has yet to prove that it can control the growth and make the sector efficient. Several economic bottlenecks remain to be dealt with in this area, including energy, technology, trade, service industries, and the lack of market information in China. [ ]

Energy prices remain relatively low, and, until China takes the painful step of raising them, energy use will remain poorly distributed and inefficient. A September article in *People's Daily* estimated that the energy consumed by rural industries in the year 2000 will reach 200 million tons of standard coal. But if the 1984 increase in energy consumption by rural enterprises continues, the estimate will be reached in roughly five years. [ ]

Technology transformation in rural industries is an important issue to the leadership, and 1985 was the beginning of a two-year "sparking plan" to develop technology in areas of the economy where quick results can be expected with a minimum of investment, such as the processing of agricultural and sideline products. More liberal financial rules have been made for enterprise investments in technology, and cadre leaving the military have been cited as contributing to the technical and management skills of rural industries. In reality, however, it is likely that technology is merely being used to get rural industries to hire the roughly 1 million soldiers who are to be demobilized. Far more technology is likely to be absorbed from heavy industry, where a small but growing number of urban technicians are being lured away by the high salaries and bonuses offered by rural industries. [ ]

Trade, both domestic and international, must also be developed for the continued economic success of rural industries. To encourage domestic trade, regional trade centers for rural and industrial goods, which are basically wholesale centers, are being set up. The value of exports from rural businesses rose to more than 4.7 billion yuan in 1984, but virtually all of the products came from the wealthier coastal provinces. Import taxes established in mid-1985 suggest that China is becoming more serious about protecting some of its fledgling industries from foreign competition. At some point in the future, China will have to shake itself free from its own bureaucracy and wean these industries from state protection if it intends to avoid the problems other developing countries have experienced in adopting import substitution policies. [ ]

Service trades and businesses are developing rapidly despite strong ideological opposition in many localities. Continued expansion of the labor service industry will be necessary both to absorb labor and to support the development of other industries. [ ]

Information and current, reliable statistics will be needed if Beijing intends to use economic levers to control the economy. The government is taking steps to improve its statistical collection system, and is undertaking surveys to assess the number and state of rural enterprises currently in operation. More financial information is also being disseminated to local enterprises to allow more rational production and marketing decisions. The fact that possibly one-fourth of China's peasants are illiterate, however, emphasizes the difficulties that China will have in disseminating market information, gathering equitable taxes from business records, and pressing toward a modern industrial society. [ ]

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